CLASH OF JURISDICTIONS: APPLICABILITY OF ISLAMIC PRINCIPLES UNDER ENGLISH

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As in any religion, one may argue, there exists a spectrum of devout belief spanning from those who strictly follow the teachings of the Qur'an, to those that rarely feel the impact of their faith on a daily basis. In countries where there are both conventional and Sharia complaint banks, there are options for every investor, devout or not, Muslim or secular. The last decade has witnessed the rapid growth of Islamic finance on both an international and domestic platform. Accompanying that growth is a rise in the number of disputes that implicate Islamic law. This fact remains constant even when the primary law of the contract is that of a common law or civil law country. If judges and law makers fail to comprehend the reasoning of Islamic finance professionals in incorporating Sharia law, the result could be precedents and codes that may hamper the growth of a multi-trillion dollar industry!

Lord Asquith had refused to apply the provisions of the Sharia Law in the case of *Petroleum Development (Trucial Coasts) Ltd. v. Sheikh of Abu Dhabi*[1]. He further quoted, *"it would be fanciful to suggest that in this very primitive region there is any settled body of legal principles applicable to the construction of modern commercial instruments"*. However, if Lord Asquith could foresee the future, he would have chosen his words wisely before delivering the far reaching judgment about the inadequacies of Sharia*Law*. Little did he know that, years later, the United Kingdom would rank ninth in the world in holdings of Sharia-compliant assets and would become the first western country to issue sovereign **sukuk**. Islamic Finance is gaining a foothold in the global financial market as a commercially viable alternative to conventional financing. Remarkably, transactions undertaken in the Islamic financial sector are no longer confined to countries whose legal systems are based on Sharia principles.

However, the Sharia compliant structures of the Islamic finance instruments face a serious impediment when it has to be implemented in a non-Islamic legal framework. Most of the countries do not have a legal mechanism to grasp and implement Sharia law in financial structures. Moreover, the western courts do not have the necessary expertise or resources in order to interpret and enforce the Islamic finance transactions and the documents which are based on principles of Sharia law.

In the first 500 years or so after the **Hijrah**, Islamic law developed rapidly to accommodate the legal needs of an Islamic Empire and its increasingly complex commercial transactions. However with the passage of time, more emphasis was given to jurists and less scope was left for original thinking based on direct reference to the Quran. This is referred to as ***the closure of the gate of Ijtihad***. The resultant outcome was a stagnation of legal thinking by the leading intellectual Muslim scholars. Thus we find that cross border Islamic Finance contracts are usually written under English law. The prime reason proved that English law provides a greater level of certainty to the contracting parties than attempting to write a contract under the rules of Islamic Law. The Global Islamic Finance Magazine recently held an interview allowing people to explain

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concisely why English law is the commonly preferred law for cross border financial Islamic transactions.

Enforcement

The Medjella is considered the first attempt to codify Islamic law and represents the endeavour of the Ottoman Empire. The Medjella dedicated an entire chapter to arbitration, stating within it that 'a decision validly given by the arbitrators in accordance with the rules of law is binding on all parties'. Decisions by arbitrators were not enforceable except upon confirmation by the judge, and then only if made in accordance with law. In the world of Sharia compliant finance, there has never been more of an openness to settle disputes through arbitration. In previous times, and to some extent today, scholars of Islamic law considered the enforcement of the award of an arbitrator to be purely discretionary by the judge.

At the outset, however, it is paramount to understand why excessive focus has been put on examining enforceability issues. Generally, parties to a transaction scrutinize the law governing the same in order to determine whether their rights and obligations would be enforced in a consistent and transparent manner. A primary function of law in any commercial and financial transaction is to provide a considerable degree of certainty and to enforce the determinations of the parties in respect to their obligations. The choice of law in regard to Islamic finance transactions is more delicate as the parties would naturally want to opt for Islamic law as the governing law of the finance documents. However, parties cannot merely adopt Islamic law as the governing law without reference to the law of a particular jurisdiction since Sharia law is not a standard codified law. Therefore, a codified legal system which exercises the principles of Sharia law is often used as the governing law in an instrument in order to provide more certainty on the rights and obligations of the transacting parties.

This embedded in the landmark case of *Shamil Bank of Bahrain EC v. Beximco Pharmaceuticals Ltd (theShamil Bank Case)*[2], which discussed the scope and interpretation of Sharia law in relation to the English law. In this case, defendants failed to make payments under the murabaha agreement (**the Agreement**) entered into with plaintiff and consecutively, the latter claimed the amount outstanding under the provisions of the Agreement. The governing clause in the Agreement stated that "*subject to the principles of the glorious Sharia, the agreement would be governed by and construed in accordance with the laws of England*". The defendants argued that the Agreement contained a hidden form of *riba* which was contrary to the principles of Sharia and was hence, unenforceable. Therefore, the foremost issue of debate at the appellate court was whether the governing law clause in the Agreement required the consideration of the Sharia law.

The Shamil Bank has been positively accepted by commentators in its two main propositions concerning Shariah as a choice of law, namely: i) the Rome Convention which requires that the law of a contract be that of a country; and ii) there can be only one law which governs a contract. The probability of this conclusion

being the same for other common law jurisdictions is very likely in addition. When the topic regarding governing the law of the Agreement arises the court held that the provisions of a contract could only be governed by a single law. Therefore, in the present case, the Agreement could not be subject to both, the English law and the Sharia law. Further, the court held that the parties were permitted to choose the governing law of a contract in accordance with the Rome Convention[3]. However, the latter convention has provided that the parties were only entitled to choose the law of a country. Further, the judge held that the general reference to the Sharia law in the Agreement did not explicitly relate to the intention of the parties to incorporate the same as the exclusive governing law. In the light of this judgment, it is implied the moral burden of structuring Sharia compliant contracts has been placed on the contracting parties due to the reluctance of English courts to permit Sharia law to be chosen as the governing law of contracts.

Structuring an Instrument in Compliance with Sharia

Apparent from the Islamic economics literature, is that interest-free instruments must guide the raising and mobilization of financial resources in an Islamic economy. This is a requirement that stems from the moral injunctions well rooted in the Qur'an and the Sunna, which form the epistemological sources of the Sharia. The Sharia invokes an extensively participatory form of profit-sharing system that can replace interest-based financial instruments. Such instruments are traditionally termed profit sharing, or *mudāraba*, and an Islamic term for a sale where the buyer and seller agree on the mark-up for the item(s) being sold better known as murabaha. The modern *murabaḥa* is considered as a crucial instrument for facilitating short-term finance for consumer and business requirements. It is used to finance household items, cars or business equipment and/or supplies. It is often used to replicate a conventional trade financing agreement. With the rise of Islamic banking since 1975, murabahah has become "the most prevalent" Islamic financing mechanism. This contract illustrates several methods that are used widely in the formulation of Islamic financial transactions. This includes the conglomeration of nominate contracts, the binding promise and the application of *takhayyur* which initially was put to systematic use in the compilation of the Majalla, completed in 1876. The principle of takhayyur has expanded extensively in its scope, and has proven to be the major expedient in the modernising legislative reforms throughout the Muslim world. These tools and legal stratagems are pivotal to the industry's gamut of financial structures. However, some of the indemnities comprised in murabaḥa transactions may fall foul under the English statutory law, in particular the Sale of Goods Act, 1979 and the Unfair Contract Terms Act, 1977.

These laws prevent the contracting parties from incorporating such indemnities into their contracts depending on the circumstances of the particular transaction. Further, the English domestic industry has faced several regulatory difficulties due to the hybrid legal structure of the Islamic financial contracts. However, the Shamil Bank Case infers that the choice of governing law which would apply to financial documents and the extent of the applicability of Sharia law principles are bound to arise in cases where an Islamic finance transaction is concluded between parties from multiple jurisdictions ***(both secular and Sharia jurisdictions).***

Consonance between Jurisdictions

Currently, English law is the most common choice of law for the governing of disputes arising under agreements purporting to adhere to Islamic principles. Some of these contracts contain no references to Islamic law and may even include a ***waiver of Shariah defense***, implying that in case of a dispute the parties agree to waive any argument that the agreement is invalid under Shariah law. Such stipulations attempt to rectify the ***Sharia risk***, which is a term that became known in the industry as the term associated with the risk that one party will fail under its contact obligations and then state the entire agreement is void for being invalid under Islamic law. This risk exists despite the fact that multinational law firms have created entire divisions dedicated to Shariah-compliant financial transactions. However, the current culture of Islamic finance is liberal, with parties beginning with the assumption that a deal is Shariah-compliant, and contracting parties are not necessarily knowledgeable of Islamic law.

Hence, the principles of Islamic finance have to be synchronized within the macro-structure of the English Law in order to maintain concord between the jurisdictions. Further, it can be perceived that financial services environment of the United Kingdom does not prevent the Islamic financial industry from simultaneously developing an alternative financial market. For instance, the government's abolition of double stamp duty in 2003 had ushered in a range of new Islamic financial activity like permitting financial institutions to offer home ownership plans based on a murabaḥa contract. Earlier, these transactions had incurred double stamp duty; first when the property was purchased by the bank and then when the property was subsequently sold to the client with a profit.

The English government also facilitated the operation of mudāraba partnerships and profit & loss investment partnerships. An important feature for the *Mudaraba* contract lies in the fact that it places equal importance on both financial and knowledge-based investment. In these partnerships, the parties providing the ideas and ongoing training for the business venture are viewed as equally important to the venture. The profit share arising from these transactions would normally not be tax deductible by the Islamic Financial Institutions as the dividends were subject to a disadvantageous tax treatment. The government resolved this issue by authorizing *mudāraba* dividends to be treated as interest paid on loans by validating tax-deductibility on these dividends through an amendment of the Finance Act of 2005.[4]

Further, the legal systems can be reconciled by standardizing the Islamic financial contracts. However, the issue of standardization is closely related to the controversial debate concerning the codification of the Sharia in any nation state. A partial solution to this problem can be achieved by encouraging the industry to incorporate specific provisions, such as the Auditing and Accounting Organization for Islamic Financial Institutions (***AAOIFI***) sharia standards into Islamic finance contracts. As long as these provisions are sufficiently specific, they can be construed to operate as a set of contractual terms agreed upon between the parties. Further, the English courts will refer to incorporated standards in their interpretation of English law contracts so that the legal substance of contracting parties' objectives is achieved. Therefore, the determinacy of such norms and standards would permit for a serene judicial interpretation.

Conclusion

The Sharia is a mechanism which governs every aspect of a Muslim's life. A practising Muslim is required to lead a just and pure life to achieve piety. In this endeavour, his/her income and expenditure must remain free of impurities (such as the receipt or payment of interest). To do otherwise would be to commit a sin. The need for Islamic finance can therefore be seen as a spiritual necessity rather than an economic convenience.

As it is apparent from the above, many cross-border Islamic finance transactions, contracts are often governed by English law with the English courts expressly having the jurisdiction to decide on the necessary disputes. The stagnating fact that an Islamic finance contract, although governed by English law, must still comply with the regulations and reformations of the principles of the Sharia in order to be rightfully enforced in order to provide for the just equilibrium of balance and correlation existing between the two systems alike. Sharia Law must develop a distinctive corporate culture, the main purpose of which is to create a collective morality and spirituality which, when combined with the production of goods and services sustains the growth and advancement of the Islamic way of life as quoted in ***The Pak Banker***.

Endnotes

1. Arbitration Between *Petroleum Dev. (Trucial Coast) Ltd. v. Sheikh of Abu Dhabi*, 1 INT'L & COM P. L. Q. 247, 250–51 (Sept.1951).

2. 1 WLR 1784 (CA 2004) (UK)

3. European convention 80/934/ECC on the law Applicable to Contractual Obligations (Rome Convention) [1980]

4. Jonathan G. Ercanbrack- The Law Of Islamic Finance In the United Kingdom (supra)